VZCZCXRO9092
PP RUEHCD RUEHGD RUEHHO RUEHMC RUEHNG RUEHNL RUEHRD RUEHRS RUEHTM
DE RUEHME #3345/01 3171529
ZNR UUUUU ZZH
P 121529Z NOV 08
FM AMEMBASSY MEXICO
TO RUEHC/SECSTATE WASHDC PRIORITY 3946
INFO RUEHXC/ALL US CONSULATES IN MEXICO COLLECTIVE PRIORITY
RUEATRS/DEPT OF TREASURY WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEHC/DEPT OF LABOR WASHINGTON DC
RHMFISS/DEPT OF ENERGY WASHINGTON DC
RHMFIUU/HQ USNORTHCOM
RHMFISS/CDR USSOUTHCOM MIAMI FL
RHEHAAA/NSC WASHINGTON DC

UNCLAS SECTION 01 OF 05 MEXICO 003345

SENSITIVE, SIPDIS

STATE FOR WHA/MEX, WHA/EPSC, EB/IFD/OMA, AND DRL/AWH
STATE FOR EB/ESC MCMANUS AND IZZO
USDOC FOR 4320/ITA/MAC/WH/ONAFTA/GERI WORD
USDOC FOR ITS/TD/ENERGY DIVISION
TREASURY FOR IA (ALICE FAIBISHENKO)
DOE FOR INTERNATIONAL AFFAIRS (KDEUTSCH AND ALOCKWOOD)
NSC FOR DAN FISK
STATE PASS TO USTR (EISSENSTAT/MELLE)
STATE PASS TO FEDERAL RESERVE (CARLOS ARTETA)

E.O. 12958: N/A
TAGS: ECON EFIN ENRG EINV PGOV MX
SUBJECT: MEXICO?S ECONOMY HIT BY GLOBAL CRISIS; PLANE CRASH
EXACERBATES FINANCIAL MARKETS? NERVOUSNESS

¶1. (SBU) Summary: Jitters over the depth of the global economic downturn, the drop in oil prices, and foreign investors? flight to quality have hurt domestic financial markets. The financial crisis and the downturn of the U.S. economy is adversely affecting the Mexican economy, reflected in a decline in manufacturing exports, a slump in remittances sent by Mexicans abroad, an expected drop in tourism and FDI flows, a lower demand for Mexican oil exports, and unemployment. The government has implemented a series of measures to help relieve liquidity pressures, stabilize the main economic variables, offset the oil revenue shortfalls, and boost the economy. The timing and effectiveness of the government?s countercyclical measures, especially the National Infrastructure Plan (NIP), and the passage of other economic reforms or will determine how effectively Mexico will weather the economic recession. The November 4 plane crash that killed the Secretary of Interior, a close friend and advisor to President Calderon, has contributed to a sense of uncertainty. While it is premature to speculate on the causes of this tragic event, the impact has shaken policy makers and markets. End Summary.

REACTION TO SECRETARY OF INTERIOR?S SUDDEN DEATH
--- ---
¶2. (SBU) The Mexican stock market's index, the IPC, fell 5.05% and the peso depreciated 0.96% to 12.60 pesos to the dollar a day after the U.S. elections and the plane crash which killed Secretary of the Interior Juan Camilo Mourino. Government officials and analysts had expected some relief in financial markets after the U.S. elections, but poor economic data in the U.S., rising jitters on the depth of the global economic recession, and what analysts have called a healthy profit-taking after a weekly gain of 28% had negative effects on the stock market.
¶3. (SBU) Finance Secretary Agustin Carstens and the Chairman of the Stock Market Guillermo Prieto maintained that it was premature to speculate on the cause of the crash which killed Mourino and on the long term impact on the economy. Both asserted that Mexico's economic fundamentals were solid and unaltered after the tragedy. The government has been implementing a series of measures to help relieve liquidity pressures and stabilize the main

economic variables. Carstens noted that Mexican financial markets are "functioning adequately and will continue to". Prieto acknowledged speculation about possible sabotage of Mourino's airplane as a response to the government's ongoing war against drugs, but stressed that until the government releases the results of the investigation, "investment plans and financial markets should not be affected."

PLANE CRASH BRINGS BACK MEMORIES OF 1994

¶4. (SBU) The government's war against drugs, surging insecurity levels and the Secretary of the Interior's sudden death brought back unpleasant memories of the assassination of Revolutionary Institutional Party's (PRI) presidential candidate Luis Donaldo Colosio in 1994 and the financial (?Tequila?) crisis that ensued. Most experts consider these fears to be premature, and speculation before the government announces the real cause of the plane crash, could be risky. The government has undertaken a thorough investigation of the crash, inviting aviation experts from the U.S. and the U.K. to assist. The government's communication strategy on the incident, informing the media and the public step-by-step on the process of the investigation and the level of cooperation with foreign governments including the U.S., as well as President Calderon's commitment to investigate the case thoroughly have helped soothe concerns. While the investigation is ongoing and may not be completed until eleven months from now, all evidence uncovered to date points to the crash being the result of an accident and

non/not sabotage.

ANALYSTS THINK GOM FUNDAMENTALS ARE SOLID

¶5. (SBU) Banamex-Citigroup's chief political and economic analyst Sergio Kurczyn told us that if the investigation concluded that sabotage was the cause of the plane crash, financial variables would undoubtedly be affected. But, more than these variables the strongest impact would be on the credibility and strength of the country's institutions. Kurczyn said he thought the pillars of public institutions had already been weakened by the tight 2006 presidential election and Andres Manuel Lopez Obrador's protests claiming electoral fraud, as well as the removal of the Federal Electoral Institute's counselors by the Congress.

¶6. (SBU) Banamex analyst Kurczyn told us he did not think Mexico would relive the political and economic crisis of 1994 and 1995. Echoing the government's views on the economic and financial situation, he noted that the economic and financial conditions are very different now from what they were more than a decade ago: Mexico has lower foreign debt (equivalent to 2.4% of GDP), high foreign reserves, a fixed exchange rate, a low inflation rate compared to other countries, well-capitalized banks, a lack of risky structured instruments, low private sector leverage, etc. Moreover, the financial crisis did not originate in Mexico this time. For Kurczyn, international confidence in Mexico's fundamentals was reflected in the Federal Reserve Bank's recent 30-billion swap line to the Bank of Mexico and the International Monetary Fund's decision to double borrowing limits for emerging-market countries. Goldman Sachs Director General in Mexico and former Finance Under Secretary, Martin Werner echoed Kurczyn's confidence in the strength of the financial institutions saying that Mexico learned its lesson and that banks are stronger. The only impact on financial institutions would be the cut in annual profits because they will be forced to increase their preventive reserves to face the rising non-performing consumer loans.

¶7. (SBU) Financial authorities and Hacienda officials have repeatedly denied the risk of a collapse of the banking

system thanks to the regulations implemented since the 1994-1995 so-called "Tequila crisis", which have strengthened financial institutions. Banks have dramatically changed the way they report their accounting and their balance sheets are available to investors' scrutiny. An exception though was the exposure of some companies to foreign exchange derivatives, which made the peso depreciate to over 14 pesos to the dollar in October. The peso depreciation led to the bankruptcy of a major Mexican retail store and left other major Mexican corporations shaky. The Finance Secretariat asserted that the demand for dollars has been supplied and that most of these operations had been closed.

¶8. (SBU) Corporations? failure to disclose their exposure to such operations made authorities realize the need for stricter supervision. The National Banking and Securities Commission (CNBV) stepped up by conducting an investigation on the companies' compliance to their obligation to report significant financial information. Lawmakers are preparing an initiative to increase disclosure of derivative positions and their potential risk. The Finance Secretariat is currently working on a specific bankruptcy law and is also looking into incorporating further controls based on the U.S. subprime experience.

CREDIT CARDS AND CONSUMER LOANS

¶9. (SBU) The increase of non-performing consumer loans, in particular credit cards, has raised concerns about bank solvency. The National Banking and Securities Commission

(CNBV) reported that the delinquency index, which measures delinquent loans as a percentage of total loans, rose from 2.82% to 3.03% during the third quarter of the year. This figure is still low compared to 16.3% in 2001. The delinquency index in consumer loans, including credit cards and automobile loans, rose from 6.92% to 7.69%. Within it, the delinquency index for credit cards grew from 8.18% in the second quarter to 9.41% in the third quarter, and from 3.9% in December of 2005. The delinquency index for housing and business loans rose from 3.05% to 3.34% and from 1.05% to 1.09%, respectively.

¶10. (SBU) Banks have raised their preventive reserves due to the increase in credit cards? overdue payments. Currently, coverage for non-performing loans is 157%, which means that for each peso owed, banks have 1.57% to cover it. Banks' current capitalization index or the capital-to-asset ratio is 15%, which is way above the required 8% by domestic and international standards. The private sector's current leverage is equivalent to 22% of GDP ? which comparies favorably to 201% in the U.S. The recent increase in credit card interest rates from an average of 34% to 42% is worrisome, especially when there is a potential risk of a higher unemployment rate in the coming months. To offset this risk, banks have reduced the issuance of credit cards and are being more careful with their credit origination procedures, both for credit cards and mortgages. The Bank of Mexico, the Finance Secretariat, other financial authorities, and banks have created a coalition to improve financial education for consumers.

CENTRAL BANK ACTIONS TO ADDRESS THE CRISIS

¶11. (SBU) To shore up the peso and tackle liquidity pressures, the central bank has engaged in daily U.S. dollar sales (USD 13.1 billion of its $84 billion foreign exchange reserves) in an attempt to break a dangerous cycle of currency weakness begetting turmoil. Foreign exchange reserves continue to be high despite this dollar injection (USD 76 billion). Other central bank policy actions include: paying interest on dollar deposits held with the central bank; repurchasing up to 150 billion pesos of

Savings Protection Bonds, which is expected to help in the sterilization process in order to reduce the amount of dollars auctioned by the central bank; establishing an interest rate swap mechanism via which local banks will be able to exchange exposure to long-term fixed interest rates for short-term variable rates; and, establishing a USD 30 billion swap facility with the U.S. Federal Reserve.

¶12. (SBU) The government announced it will reduce the supply of its long-term securities in its fourth quarter 2008 auction program and the weekly issuance of Savings Protection Bonds. The GOM will temporarily permit financial institutions to buy and sell government instruments from investment funds that are part of the same financial group. The government is providing guarantees on commercial paper via development and mortgage banks. The most recent measure announced by the Finance Secretariat is the buy-back of up to USD 3.2 billion of debt (bonds with maturities between 10 and 30 years) in an effort to drive down long-term yields. The government expects liquidity pressures to stabilize during the first quarter of 2009, but will extend these measures if needed.

¶13. (SBU) On Oct. 8th, President Calderon announced his Program for Growth and Employment aimed at mitigating the impact of the global economy's deterioration and credit crunch. The Program for Growth and Employment focuses boosting the economy by increasing public spending on infrastructure projects. The elimination of Pidiregas (long-term debt for infrastructure projects), included in the program will enable the government to convert Pidiregas

liabilities into public debt and exclude Pemex's capital expenditures from the balanced budget. This measure will give the government an additional USD 6 billion to spend on infrastructure. The initiative will also allow Pemex to use its current stabilization fund of approximately USD 923 million to build a refinery.

OIL PRICE AND THE RISK OF REVENUE SHORTFALLS

¶14. (SBU) Due to the deterioration of the global economy, the government had to submit revised economic projections to the Congress. GDP growth, the Mexican oil mix price, the exchange rate were revised downward from 3% to 1.8%, from USD 80.3 to USD 70 per barrel, and from 11.20 pesos to the dollar to 11.70 pesos to the dollar, respectively. The 1.8% GDP growth seems too optimistic given the depth of the global financial crisis and the sharply downgraded outlook for the U.S. economy. In its World Economic Outlook 2008, the IMF projects a GDP growth of 0.9% in 2009 from the previous projection of 1.8%. There are growing concerns that lower economic growth and the decline of international oil prices could lead to a revenue shortfall next year.

¶15. (U) The Finance Secretariat assures that it will not have to cut spending next year particularly in infrastructure projects, security, and social development as it has a cushion of USD 4.3 billion in the Oil Stabilization Fund. The government is also confident that a weaker peso will compensate for the oil price fall. The stabilization fund would be sufficient if the Mexican oil price falls from the USD 70 per barrel set in the budget to USD 60 per barrel. However, the Mexican oil mix price keeps on falling and on November 5 it closed at USD 43 per barrel. The government might have already hedged a chunk of its oil exports, according to analysts, although it is unlikely that the Finance Secretariat will acknowledge this fact. The Finance Secretariat continues to gradually eliminate the gasoline subsidy.

¶16. (SBU) The elimination of Pidiregas will allow the government to have a fiscal deficit of 1.8% of GDP, which will help the government funnel resources to countercyclical measures, such as the development of

infrastructure projects. Next year, the government will spend USD 10.6 billion against the USD 18.5 billion disbursed in 2008. The government also requested the Congress to increase its indebtness levels and incur in foreign debt of USD 5 billion with multilateral financial organizations. The Finance Secretariat is confident that if required it will have access to those loans since the Mexican government prepaid USD 9 billion of its foreign debt in 2006. Leftist economist Rogelio Ramirez de la O and other critics strongly believe the government should cut its current expenses and bureaucrats' salaries to help offset the revenue shortfalls.

HOW THE CRISIS AFFECTS MEXICO?S REAL ECONOMY

¶17. (SBU) Tourism, oil and trade. The financial crisis and the downturn of the U.S. economy is having an adverse impact on the Mexican economy through various channels: a decline in manufacturing exports, a slump in remittances sent by Mexicans abroad, a drop in tourism and FDI flows, a lower demand for Mexican oil exports, and unemployment. About 85% of Mexico?s foreign trade is tied to the U.S. economy. The exports value of manufactured goods declined by 3.8% yoy in August. Non-oil exports to the U.S. fell by 6.6% and with them, automobile sales to the U.S. dropped by 16.4%. From January thru June, foreign direct investment dropped 24% and tourism inflows are expected to slow next year.

¶18. (SBU) Migrants and remittances. The lower remittances will likely have a negative impact on domestic consumption

and housing construction. From January thru September, remittances have fallen by 3.7%. In July alone, they dropped by 7%. The potential return of thousands of Mexicans who have lost their jobs in the U.S. construction sector will put pressure on Mexico?s job creation. Mexico?s official unemployment rate reached a record of 4.25%.

¶19. (SBU) Financial markets. Jitters on the depth of the global economy, the drop in oil prices, and foreign investors? flight to quality from peso-denominated bonds to U.S. Treasuries have hurt Mexico?s financial markets. The stock market's main index, the IPC, has plunged and the peso has suffered a major depreciation against the dollar during the past months. The peso has lost 33% from its strongest level of 10 pesos to the dollar last July and the IPC has fallen 31.5% during the year. The country-risk premium closed at 405 basis points on November 7 from 141 basis points in December 2007. The yield of the 30-year bond reached 11.30% on October 24 before the government?s actions to address liquidity problems, but by November 4 it had fallen to 8.8%. Short-term yields? performance will continue to depend on the inflation, which reached 5.78% in October on higher gasoline and electricity prices. The central bank?s benchmark overnight lending rate is 8.25%. The Bank of Mexico expects the inflation to begin to recede in the second quarter of 2009. Foreign currency flows have also declined. The Bank of Mexico is projecting a current account deficit of between 1.6% and 2% in 2009. One of the most pessimistic projections is that from Banamex with a 2.8% deficit.

COMMENT

¶20. (SBU) Comment: The government's war against drugs, the deteriorating security situation and the Secretary of the Interior's sudden death raised fears here that Mexico would experience another ?Tequila? crisis, much like the one which ensued after the assassination of PRI presidential candidate Luis Donaldo Colosio in 1994. Experts, however, caution against jumping to such conclusions. The government has made extraordinary efforts to soothe worried investors by constantly referring to Mexico?s well-ordered

finances and macroeconomic variables, but Mexico?s integration with the U.S. economy will undoubtedly impact the country?s economy. On the financial front, the Finance Secretariat and the Bank of Mexico seem to have been reacting promptly to tackle liquidity pressures and the financial crunch. The timing and effectiveness of the government?s countercyclical measures, especially the National Infrastructure Plan, and the passage of other economic reforms will determine not only how well Mexico weathers the economic recession, but also how fast the country will succeed in its insertion into the global economy. End Comment.

GARZA